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The New Starker: A Nonsimultaneous Exchange Expands Section 1031/ Collateral Estoppel Clarification

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The New *Starker*: A Nonsimultaneous Exchange Expands Section 1031/ Collateral Estoppel Clarification

The new Starker decision addresses the issue whether a nonsimultaneous exchange qualifies for section 1031 nonrecognition treatment. The Court of Appeals for the Ninth Circuit, in addressing this issue, also had to determine the appropriateness of the collateral estoppel "separable facts" doctrine under the facts in the case. The author provides an in-depth examination of the court's clarification of collateral estoppel and expansion of section 1031. The author, in agreeing with the decision, welcomes the added flexibility the case lends to the real estate finance field.

I. INTRODUCTION

Pursuant to section 1031(a)[1] of the Internal Revenue Code, no gain[2] or loss[3] shall be recognized,[4] if property held for use in

1. The Internal Revenue Code provides in relevant part:

(a) Non-recognition of gain or loss from exchanges solely in kind.
No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interests, or other securities or evidences of indebtedness or interest) is exchanged solely for property of like kind to be held either for productive use in trade or business for investment.

I.R.C. § 1031(a).

2. In order to give the reader a better insight to the case, the following terms, used through this note, are defined as follows: Gain—"The gain from a sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 [of the Internal Revenue Code] for determining gain . . . ." I.R.C. § 1001(a).

Loss—"The loss shall be the excess of the adjusted basis over the amount realized." I.R.C. § 1001(a).

Recognition—"The entire amount of the gain or loss on the sale or exchange of property shall be recognized [taxable] subject to specific exceptions." I.R.C. § 1001(c).

Like kind property—"Refers to the nature or character of property. Property of the same class is like kind property; therefore, exchanging improved or unimproved property qualifies for nonrecognition of gain or loss." Treas. Regs. § 1031(b) (1967).

Tax-free exchange—This term is somewhat of a misnomer. The author, when referring to a tax-free exchange, is actually referring to a tax-deferred exchange pursuant to section 1031 of the Internal Revenue Code.

Taxpayer—The person seeking tax-deferred exchange treatment on the disposition of his property.

Buyer—The accommodation party in the exchange. Generally, this party will eitrade or business or for investment is exchanged for "like kind"[5] property. This is an important exception to the general rule that all gain or loss realized on the sale or exchange of property must be recognized for federal tax purposes.[6]

Until recently, it was thought that in order for an exchange to qualify under section 1031, the exchange of title had to take place simultaneously.[7] However, in the recent case of *Starker v. United States*[8] the Court of Appeals for the Ninth Circuit held that certain nonsimultaneous exchanges can qualify as section 1031 exchanges. This decision could have a potentially great impact on the real estate investment market because it removes one of the major difficulties in accomplishing a tax-free exchange.[9] This difficulty has been the complexity involved in the arrangement of simultaneous transfers of title in multiparty transactions.[10]

This note will examine several issues in *Starker* with a special emphasis on the nonsimultaneous exchanges. The note will begin with an examination of the pertinent facts of *Starker*, followed by a brief historical view of the law concerning collateral estoppel. The note will then discuss the impact of the court's analysis of collateral estoppel and the court's treatment of like kind exchanges.

II. THE FACTS OF THE CASE

On April 1, 1967, T.J. Starker (T.J.), his son and daughter-in-law, Bruce and Elizabeth Starker, entered into a "land exchange agreement" with Crown Zellerbach Corporation (Crown). The agreement provided that the three Starkers would convey their interests in 1,843 acres of timberland in Oregon and Washington to Crown. Crown agreed, in return, to acquire and deed to the

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ther be the seller of the property that the taxpayer acquires in the exchange or the ultimate buyer of the taxpayer's property.

Exchange property—property received by the taxpayer.

3. *See* note 2 *supra*, and accompanying text.

4. *Id.*

5. *Id.*

6. "Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property *shall* be recognized." I.R.C. § 1001(c) (emphasis added).

7. *See* Note, *The Five-Year Like-Kind Exchange*, 55 NEB. L. REV. 511 (1976) (discussing the implications of *Starker I*).

8. 602 F.2d 1341 (9th Cir. 1979) [hereinafter cited as *Starker*].

9. This is due to the fact that very few natural exchanges exist. Taxpayers usually set up agreements that require the buyer to purchase exchange property from third parties solely for the purpose of exchange. One of the major barriers to this type of exchange has been the difficulty in arranging the simultaneous transfer of titles. The *Starker* holding removes this barrier. This aspect will be discussed thoroughly under the section 1031 impact section of this note.

10. *See* note 9 *supra*, and accompanying text.

Starkers other real property suitable to the Starkers within a five year period, or to pay the outstanding balance in cash. In addition to account for timber grown (if necessary) over the five year period, a "growth factor" of six percent of the outstanding balance was to be credited to the Starker account on an annual basis.

On May 31, 1967, the Starkers deeded their property to Crown, with Crown entering a $1,502,500 exchange value credit on its books for T.J. and a $73,000 credit for Bruce and Elizabeth. Within four months, Bruce and Elizabeth designated, and Crown purchased and conveyed, suitable property pursuant to the contract. This conveyance fulfilled Crown's obligation to Bruce and Elizabeth, and no cash was transferred.

The closing of the transaction with T.J. took a longer period of time due to the large credit balance. Between 1967 and 1969, Crown purchased twelve parcels designated by T.J. from third parties. Of these twelve parcels, nine were conveyed to T.J.. At T.J.'s direction, two of the twelve parcels (hereinafter designated as the Timian and Bi-Mart properties) were conveyed to his daughter, Jean Roth. Title was never in T.J.'s name as to these properties.

The final property (the Booth parcel) was a commercial parcel, title to which was never conveyed to T.J.. Crown acquired a third party's contract right to purchase the property, and then reassigned the contract right to T.J.. This third party's contract right arose under a 1965 sales agreement on the Booth land. Under that agreement, the original transferor held a life estate in the property and legal title did not pass until the life estate expired. Meanwhile, the holders of the contract to purchase were entitled to possession, subject to certain restrictions. These restrictions prohibited the purchasers from removing improvements and required them to keep buildings and fences in good repair. Pursuant to the agreement, a substantial portion of the purchase price was to have been invested, with a fixed return to be paid to the purchaser of the life interest. If there was a default on any of these conditions, the agreement provided that the sellers could elect to rescind the contract.

The first real property transfer was on September 5, 1967. The twelfth and last transfer was on May 21, 1969. By 1969, T.J.'s credit balance had increased from $1,502,500 to $1,577,387.91 due to the six percent growth factor. The twelve properties transferred by Crown to T.J. (and Jean Roth) had a value of $1,577,387.91. Hence, no cash was paid to T.J.. His balance was reduced to zero; thus, the transaction was concluded with no gain or loss to either party.

In 1967, the Starkers reported no gain on their respective income tax returns, claiming nonrecognition treatment under section 1031 of the Internal Revenue Code.[11] The Internal Revenue Service disagreed and assessed deficiencies of $35,248.41 against Bruce and Elizabeth and $300,930.31 against T.J.. The Starkers paid the deficiencies and filed claims for refunds. When the claims for refunds were denied, the Starkers filed two actions for refunds in the United States District Court in Oregon.

In the first case, *Starker v. United States*,[12] Judge Solomon held that *Alderson v. Commissioner*[13] compelled a decision for the taxpayers. Although *Alderson* did not involve a nonsimultaneous exchange, it did allow great latitude in transacting three-corner exchanges.[14] The court particularly approved the designation of the exchange property by the taxpayer and approved a provision in the exchange agreement that allowed the taxpayer to sell for cash if it was impossible to effectuate an exchange.[15] Both of these provisions were also included in the Starker-Crown agreement.

Bruce and Elizabeth recovered the tax refund. The Internal Revenue Service appealed, but voluntarily withdrew the appeal. Thus, the judgment for Bruce and Elizabeth Starker became final.[16]

In the second case, *Starker v. United States*,[17] the Government asserted that T.J. was not entitled to nonrecognition treatment and that he was liable for tax on the growth factor as a disguised interest.[18] The district court held for the Government on both issues.[19] T.J. appealed on three contentions: first, the Government was collaterally estopped from litigating the issue; second, the

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11. *See* note 1 *supra*, and accompanying text.
12. 75-1 T.C.M. (CCH) 9443 (D. Or. 1975) [hereinafter cited as *Starker I*].
13. 317 F.2d 790 (9th Cir. 1963).
14. *See* note 76 *infra*, and accompanying text.
15. 317 F.2d at 779-83.
16. 602 F.2d at 1343.
17. 432 F. Supp. 864 (D. Or. 1977) [hereinafter cited as *Starker II*].
18. Starker and Crown included in their exchange agreement a "growth factor" of six percent. This factor was to be multiplied by the outstanding Starker credit balance on Crown's books. The growth factor was to account for timber growth until the exchange was completed. The Government argued that this amount was merely disguised interest and therefore taxable to the taxpayer as ordinary income. 602 F.2d at 1343, 1356.
19. Judge Solomon, who heard both *Starker I* and *Starker II*, reversed himself with remarkable candor by saying:

> I have reconsidered my opinion in *Starker I*. I now conclude that I was mistaken in my holding as well as my earlier reading of *Alderson*. Even if *Alderson* can be interpreted as contended by the plaintiff, I think that to

trial court erred in holding his transaction with Crown did not qualify for nonrecognition treatment under section 1031; and finally, that the transaction did not cause him to have ordinary income from the "growth factor." The court addressed the issue of collateral estoppel first because the determination of that issue would directly affect the Government's right to litigate the other issues.

III. COLLATERAL ESTOPPEL ISSUE

A. Historical Preview

Collateral estoppel is an aspect of the doctrine of res judicata[20] that precludes relitigation of issues previously adjudicated.[21] A judgment in a prior action may be held conclusive as to issues in a subsequent case, even though the later case technically involves a different cause of action.[22] The role of collateral estoppel in the

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do so would be improper. It would merely sanction a tax avoidance scheme and not carry out the purposes of § 1031.

432 F. Supp. at 868.

20. The term "res judicata" covers the general law of finality and effect of prior judgments as influencing subsequent litigation. RESTATEMENT OF JUDGMENTS, ch. 3 Introductory Note (1942) [hereinafter cited as RESTATEMENT]; RESTATEMENT (SECOND) OF JUDGMENTS, ch. 3; Introductory Note (Tent. Draft No. 1, 1973). Although collateral estoppel is sometimes regarded as a branch of res judicata, the two doctrines are quite different. Both involve the conclusive effect of judgments in the subsequent actions. The difference lies in the fact that in res judicata, the subsequent suit involves the same cause of action, while in collateral estoppel the subsequent suit involves the same issue. *See* GREEN, BASIC CIVIL PROCEDURE 207-24 (1972).

21. Other doctrines under the general "res judicata" heading include merger, bar, and direct estoppel. Merger and bar preclude parties from relitigating the same cause of action. If a judgment was rendered for the plaintiff, his cause of action is merged in the judgment and he cannot, thereafter, bring another suit on the same cause of action. RESTATEMENT, *supra* note 20, at §§ 45(a), 47. *E.g.*, Dearden v. Hey, 304 Mass. 659, 24 N.E.2d 644 (1939). If a judgment is rendered on the merits against the plaintiff, the original cause of action is barred. RESTATEMENT, *supra* note 20, at §§ 45(b), 48. *E.g.*, Thompson v. Washington National Bank, 68 Wash. 42, 122 P. 606 (1912). Direct estoppel precludes the plaintiff from litigating the same issue that was litigated in a prior action. For example, if an action is dismissed for the nonjoinder of a third party as defendant, and the plaintiff brings another action on the same cause of action, the necessity of joinder may not be relitigated. Where a judgment for the defendant is not based on the merits, however, the plaintiff is not barred from maintaining a subsequent action. RESTATEMENT, *supra* note 20, at §§ 45(d), 49.

22. Collateral estoppel may apply to questions of law as well as fact, provided that both causes of action arise out of the same subject matter or transaction. RESTATEMENT, *supra* note 20, at § 70. *E.g.*, Tait v. Western Md. Ry. Co., 289 U.S. 620, 626 (1933); United States v. Moser, 266 U.S. 236, 241-42 (1924).

judicial system is to conserve judicial energy,[23] avoid excessive litigant expense,[24] and to minimize inconsistent results.[25] Countervailing policy concerns include: the right of each person to have his day in court;[26] the danger of perpetuating error;[27] and other considerations of fairness.[28] Whether a court will apply collateral estoppel in a given case will often be determined by weighing these conflicting concerns.[29]

Where collateral estoppel is asserted between parties to a suit, the party who claims the benefit of collateral estoppel (proponent) must show that the very fact or point presently at issue was

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23. Commissioner v. Sunnen, 333 U.S. 591, 597 (1948) (the Court stated the doctrine "rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations"); *In Re* Hitchings, 342 F.2d 80, 85 (D.C. Cir. 1965) (a normal goal of res judicata is the conservation of judicial time and energy); Westgate-Sun Harbor Co. v. Watson, 206 F.2d 458, 462 (D.C. Cir. 1953) (a goal of res judicata is to conserve judicial time and energy and to promote the goal of an orderly judicial process); Polasky, *Collateral Estoppel—Effects of Prior Litigation*, 39 IOWA L. REV. 217, 219 (1954) [hereinafter cited as Polasky]; von Moschizisker, *Res Judicata*, 38 YALE L.J. 299, 300 (1929).

24. Liddell v. Smith, 345 F.2d 491, 493 (7th Cir. 1965) (it is the public policy and interest of the state that there should be an end to litigation as there is a financial hardship if a litigant is vexed twice for the same cause of action); Wallingsford v. Larcon Co., 237 F.2d 904, 906 (8th Cir. 1956) (where the party to be affected has litigated or had an opportunity to litigate the same matter in a former action in a court of competent jurisdiction, they should not be permitted to litigate it again to the financial harassment of their opponent); Hyman v. Regenstein, 222 F.2d 545, 549 (5th Cir. 1955) (a man should not be vexed twice for the same cause of action); Van Dyke v. Kuhl, 171 F.2d 187, 188 (7th Cir. 1948) (a man should not be vexed twice for the same cause of action).

25. *Developments in the Law—Res Judicata*, 65 HARV. L. REV. 818, 820 (1952) [hereinafter cited as *Developments*]. The same general policy concerns pervade all aspects of res judicata. *See* Polasky, *supra* note 23, at 219. Consequently, policy discussions that apply to one aspect of res judicata may be relevant for other aspects as well. *E.g., Developments* at 840 n.161.

26. The right to a day in court is required under the Due Process Clause. Hansberry v. Lee, 311 U.S. 32, 42-43 (1940); Postal Tel. Cable Co. v. City of Newport, 247 U.S. 464, 476 (1918). Courts, however, have discussed the right in general terms without mentioning constitutional mandates. *See, e.g.*, United States v. Silliman, 167 F.2d 607, 614 (3d Cir. 1948).

27. United States v. Stone and Downer Co., 274 U.S. 225, 236 (1927). Res judicata rests upon the assumption that the party affected, or some other party with whom he is in privity, has litigated, or had an opportunity to litigate, the same matter in a former action in a court of competent jurisdiction. It has been suggested that the problem of error perpetuation may be greater where complex legal issues are involved. Devine v. Commissioner, 500 F.2d 1041, 1048 (2d Cir. 1974). *Contra*, Blonder-Tongue Laboratories, Inc. v. University of Ill. Foundation, 402 U.S. 313, 331-34 (1971); Evans & Robins, *The Demise of Mutuality in Collateral Estoppel (The Second Round Patent Suit—The Not-So-Instant Replay)*, 24 OKLA. L. REV. 179, 205 (1971).

28. *E.g.*, Title v. Immigration & Naturalization Serv., 322 F.2d 21, 24 (9th Cir. 1963).

29. Tipler v. E.I. duPont deNemours & Co., 443 F.2d 125, 128 (6th Cir. 1971) (collateral estoppel is qualified or rejected when its application would contravene an overriding public policy or result in manifest injustice); Seven-Up Co. v. Bubble Up Corp., 312 F.2d 472, 477 (3d Cir. 1963).

litigated by the parties, and necessarily determined by a tribunal in a prior action.[30]

1. Litigated by the Parties

Parties to the initial litigation do not always raise every issue or point which might conceivably be relevant to the claim or defense.[31] In *Cromwell v. County of Sacramento*,[32] the Supreme Court addressed some of the reasons why every claim is not contested to the utmost. The Court stated: "[T]he smallness of the amount or the value of the property in controversy, the difficulty of obtaining the necessary evidence, the expense of litigation . . . [are reasons why every claim is not litigated to its fullest extent]."[33] Other reasons include the fear of drawing the court's attention from a strong claim to a weak one or of confusing the issues by introducing collateral issues.

If a party omits some issue or point from the first action he is precluded by a judgment from later raising that issue or point in a subsequent action.[34] To this extent, the parties are under pressure to litigate the first cause of action to the utmost.

The proponent has the burden of introducing evidence to show that the issue or point presently at issue was also at issue in a former action. Generally, matters are put in issue by the pleadings.

30. Spilker v. Hankin, 188 F.2d 35, 38-39 (D.C. Cir. 1951); Greenfield v. Mather, 32 Cal. 2d 23, 35, 194 P.2d 1, 8 (1948); Vestal, *Preclusion/Res Judicata Variables; Adjudicating Bodies*, 54 GEO. L.J. 857, 858 (1966). For example, collateral estoppel will be applied only to issues that actually were litigated and determined in the previous action and that were essential. Yates v. United States, 354 U.S. 298, 337-38 (1957); Cromwell v. County of Sacramento, 94 U.S. 351, 354-55 (1876); *see* Comment, *Collateral Estoppel by Judgment*, 56 HARV. L. REV. 1, 10-15 (1942); the court in Evergeens v. Nunan, 141 F.2d 927, 928-29 (2d Cir. 1944), *cert. denied*, 323 U.S. 720 (1944), distinguished between "ultimate" and "mediate" facts. Only determinations of ultimate facts, upon whose combined occurence raises the duty, or right in question, would be conclusive in subsequent actions. Mediate facts were described by the court as facts which infer the existence of other facts upon which the law raises a duty or right. 141 F.2d at 928. The policy behind this distinction is explored in Polasky, *supra* note 23, at 237-38. For a catalog and discussion of other principles that may limit the application of collateral estoppel, see *Developments, supra* note 25, at 840-50.

31. Polasky, *supra* note 23, at 222; RESTATEMENT, *supra* note 20, at § 68(2); Comment, *Consent Judgment as Collateral Estoppel*, 108 U. PA. L. REV. 173, 177-78 (1959).

32. 94 U.S. 351 (1877).

33. *Id.* at 356.

34. *See generally Collateral Estoppel & Judgment*, 56 HARV. L. REV. 1 (1942); Polasky, *supra* note 23; *Developments, supra* note 25, at 840-50.

However, they may also be put in issue by the proof without being reflected in the pleadings.[35] Clearly the pleadings of a previous action are available for the purpose of establishing what was at issue, but the proof is not limited to the pleadings. Any portion of the record in the prior action may also be used.

2. The Issue Must Have Been Determined

The fact or point placed in issue by the parties in a prior action, must also have been determined by the court in that action before collateral estoppel can be asserted.[36] It is this determination which binds the parties, if all other requisites of collateral estoppel are met.[37]

A frequent problem is presented by the need to show in the second action what was actually determined in the first. This problem is most acute when there is a general jury verdict, which is often ambiguous. Unless the ambiguity is resolved by admissable evidence, the proponent will be precluded from asserting collateral estoppel unless any possible ground for the former decision is legally sufficient to bring him the result he desires.[38]

3. Determination Necessary to the Result

For collateral estoppel to be applicable, in regard to a fact issue, determination of the issue must have been necessary to the result in the first action.[39] This requirement can be illustrated by the

35. *See generally* J. FLEMING JR., CIVIL PROCEDURE (1965) [hereinafter cited as FLEMING]. The author states:

> Most if not all modern systems provide for the amendment of pleadings at (or after) trial to conform to the proof where an issue not included in the pleadings is litigated by consent of the parties. And this consent need not be expressed. It may be inferred from the conduct of the party, such as the failure to object to evidence or the introduction of counter-evidence to meet it.

Id. § 5.7 at 168 (footnotes omitted).

36. *E.g.*, Cromwell v. County of Sacramento, 94 U.S. 351 (1876); Buromin Co. v. National Aluminate Corp., 70 F. Supp. 214 (D. Del. 1947). *Contra*, Denio v. City of Huntington Beach, 74 Cal. App. 2d 424, 168 P.2d 785, *cert. denied*, 329 U.S. 773 (1946); Equitable Life Assur. Soc'y v. McKeithen, 130 Fla. 568, 178 So. 127 (1938). *See also* Polasky, *supra* note 23, at 222.

37. The other requisites of collateral estoppel included: first, that the issue was litigated by the parties; and second, that the issue was necessarily determined by the parties. For an in-depth discussion of collateral estoppel *see* FLEMMING, *supra* note 35, at 575.

38. *See* Myrha v. Park, 193 Minn. 290, 258 N.W. 515 (1935). The court, with reference to the plaintiff trying to avoid collateral estoppel, stated: "But plaintiff can get no comfort therefrom because a finding upon *any* of the fact issues here involved against him defeats his present claim as fully and as effectively as did the verdict in the prior case." *Id.* at 295-96, 258 N.W. at 518 (emphasis added).

39. *See* Maze v. Mihalovich, [1979] Mass. App. Ct. Adv. Sh. 578, 387 N.E.2d 196 (1979) ("[Collateral estoppel applies to] matters which were necessarily involved

following example. An initial cause of action is filed for personal injury caused by *C*'s negligence. It ends in a judgment for the defendant pursuant to an explicit finding that plaintiff's conduct constitutes contributory negligence. The court also explicitly finds that *C* is negligent. The finding that *C* is negligent is held not binding in a later action because it is not necessary to support the prior judgment, although explicitly made.[40] It is not an alternative ground for the judgment, because its' tendency is to work in the opposite direction of the judgment.

Three practical considerations support this rule. First, the parties' attention and efforts are likely to be focused on points and matters which are necessary to the result. Second, the tribunal's attention is likely to be focused on the grounds necessary for its decision. Finally, unnecessary findings are usually not subject to appellate review.

4. The *Sunnen* Doctrine (Separable Facts Test)

In *Commissioner v. Sunnen*,[41] the United States Supreme Court

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and all issues which [were] actually tried and determined."); Albano v. Jordan Marsh Co., 5 Mass. App. Ct. 277, 362 N.E.2d 219 (1977).

40. This illustration is based upon the factual situation of Cambria v. Jeffery, 307 Mass. 49, 29 N.E.2d 555 (1940). *See also* RESTATEMENT, *supra* note 20, at § 68, Comment O, Illustration 10 (citing the facts of *Cambria*).

41. 333 U.S. 591 (1948). The taxpayer in *Sunnen* was an inventor who had licensed a corporation, which he controlled, to manufacture various devices under a series of contracts beginning in 1928. The taxpayer then assigned these contracts to his wife.

In a previous case, the Board of Tax Appeal had dealt with the taxpayer's income tax liability for the years 1929-31 under a contract made in 1928. In that case, the Commissioner had contended that the income of the assigned contract was taxable to the taxpayer, but the Board of Tax Appeals found for the taxpayer (Sunnen). In the second case, involving the years 1937 through 1941, income from the 1928 contract was again in question, as well as income from virtually identical contracts which had not been in question in the first litigation. The taxpayer asserted that collateral estoppel barred attempts to tax the income from any of the licensing contracts to him. The Tax Court held that collateral estoppel applied to the 1928 contract, so that its income could not be taxed to the taxpayer, but that the doctrine did not apply to the other contracts. *See* Joseph Sunnen, 6 T.C. 431 (1946). In regard to the other contracts, the Tax Court held that intervening decisions had changed the law since the first case, and that the income arising from these contracts was taxable to the taxpayer.

The Court of Appeals for the Eighth Circuit affirmed as to the 1928 contract, but reversed on other grounds without reaching the issue of collateral estoppel on the other contracts. Commissioner v. Sunnen, 161 F.2d 171 (8th Cir. 1947). On certiorari, the Supreme Court reversed the eighth circuit entirely, thus awarding the Commissioner a complete victory. Commissioner v. Sunnen, 333 U.S. 591 (1948). The Supreme Court held that the later contracts had not been before the Board in attempted to end the confusion surrounding the application of collateral estoppel. *Sunnen* involved the question of the application of collateral estoppel in tax law, and was concerned with the careful restriction of collateral estoppel where circumstances of fact or law have changed, or are dissimilar, between two actions. The Court restricted the use of facts in situations where the two actions were not identical. But the Court expressed this restriction by the following:

> [I]f the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does not govern the legal issues which occur in the second case. Thus, the second proceeding may involve an instrument or transaction identical with, but in a form separate from, the one dealt with in the first proceeding.[42]

The Court's statement encompassed two well established concepts in traditional collateral estoppel doctrine: first, that collateral estoppel does not govern purely legal issues which recur in a second case; and second, no matter how much a case factually resembles one previously litigated, no collateral estoppel concerning an issue exists if that particular issue has not been litigated.[43]

However, the language in *Sunnen* has been met with varying interpretations. For example, in *Philco v. United States*,[44] a warranty offer had been interpreted as a "price adjustment" for tax purposes in a prior suit. The Tax Court, citing *Sunnen*, refused to apply collateral estoppel because "distinct and separate transactions" were involved.[45] But the warranty offers, which were the basis of judgment in each case, had not changed between actions. In another case, *Alexander v. Commissioner*,[46] involving repetitious claims, the Tax Court found that there had been no change of material facts.[47] Collateral estoppel was invoked since the same question which confronted the Tax Court in the prior litigation was apparently being presented again. However, in the Tax Court's zeal to compare only the "events and legal principles" of the two actions, it overlooked the possibility that other circumstances might have changed since the last action,[48] even though

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the previous case, and therefore, no estoppel existed. The Court also held that with respect to the original 1928 contract, although the same subject matter had already been adjudicated, intervening changes in the law made collateral estoppel inapplicable.

42. 333 U.S. at 601 (footnotes omitted).

43. The first judgment is conclusive only "as to the point or question actually litigated." Cromwell v. County of Sacramento, 94 U.S. 351, 353 (1876). This language is also cited in Southern Pac. R.R. v. United States, 168 U.S. 1, 50 (1876).

44. 214 F. Supp. 892 (E.D. Pa. 1963), *aff'd*, 335 F.2d 882 (3d Cir. 1964).

45. 335 F.2d at 894. After rejecting the collateral estoppel doctrine, the court indicated that stare decisis may still be used. 214 F. Supp. 894.

46. 22 T.C. 318 (1954), *rev'd in part*, 224 F.2d 788 (5th Cir. 1955).

47. 22 T.C. at 320.

48. Alexander v. Commission, 224 F.2d 788, 792 (5th Cir. 1955).

the "forms" of the action were identical. Thus, the *Philco* and *Alexander* cases seem to take *Sunnen*'s concepts too literally in the first instance, and to miss the focus of the case altogether in the second.

The *Sunnen* "separate facts test" is significant in that the doctrine was in full force when *Starker I* was decided. However, subsequent to *Starker II* the United States Supreme Court in *Montana v. United States*[49] limited the *Sunnen* test to cases in which there had been a significant change in the legal climate.[50] The Court held collateral estoppel applicable, although some facts differed in the two cases, because the differing facts were not "essential to the judgment" or "of controlling significance" in the first case.[51] Thus, the question presented in *Starker II* was how should the court of appeals apply collateral estoppel, pursuant to the *Montana* test, to a fact situation originally controlled by the *Sunnen* "separable facts test."

B. The Court of Appeals' Analysis

In analyzing the collateral estoppel issue in *Starker*, the court examined the three pertinent questions involved in the determination of that issue. First, was the issue litigated by the parties? Second, were the same or similar facts involved in the prior litigation? Finally, was the proponent of collateral estoppel a party to the prior litigation? The following section will examine these questions as applied in *Starker*, concluding with the possible impact of the court's holding.

1. Litigation by the Parties

The Court of Appeals for the Ninth Circuit held that the Government was collaterally estopped from litigating the application of section 1031 to T.J.'s transaction with Crown as to nine of the twelve parcels due to the *Starker I* decision.[52] In its analysis, the court initially looked at the legal questions presented in both *Starker I* and *Starker II*. In *Starker I* the Government argued that no "exchange" took place because the reciprocal transfers

49. 440 U.S. 147 (1979).
50. *Id.* at 161.
51. *Id.* at 159-60.
52. Three of the parcels, Timian, Bi-Mart and Booth, were sufficiently different in several aspects from the properties litigated in *Starker I* to preclude the application of collateral estoppel.

were not simultaneous and that Bruce and Elizabeth received mere promises in consideration for their timberland. In *Starker II*, instead of declaring that no exchange took place because of the lack of simultaneous transfers, the Government contended that if there was an "exchange," it was not an exchange of like kind property because the exchange was not simultaneous *and* because of the possibility of T.J. receiving cash instead of property. Despite the change in the verbal formula, the Government's argument was substantially the same in *Starker I* and *II.* In both cases the Government argued that the Starkers received mere promises and that section 1031 did not apply.

The court analyzed the collateral estoppel issue using the Tentative Draft of the Restatement (Second) of Judgments.[53] Section 6 of the tentative draft enumerates four factors to be considered by a court in deciding what issues were determined in a prior action: (1) Was there a substantial overlap between the evidence or argument advanced in the second proceeding and that advanced in the first? (2) Does the new evidence or argument involve the application of the same rule of law as that involved in the prior proceeding? (3) Could pretrial preparation and discovery in the first proceeding reasonably be expected to have embraced the matter to be presented in the second? (4) How closely related are the claims?

Several facts led the court to reject the Government's argument that the legal questions in *Starker I* and *II* were severable. First, the Government's argument in both *Starker I* and *Starker II* relied on the same sentence and the same subsection of the Internal Revenue Code.[54] Second, the Government relied on the same precedent and legislative history in both cases.[55] Finally, the Government made the same point (the Starkers received mere promises) and conclusion (section 1031 does not apply) in both cases, with only the connecting arguments differing.[56] The court also pointed out that the Government did not argue the plain meaning of "exchange" or "like kind" within the statutory language,[57] suggesting that had the Government emphasized the meaning of "like kind" and "exchange," the emphasis of the words in the two cases would have been relevant.

53. RESTATEMENT (SECOND) OF JUDGMENTS § 68 (Tent. Draft No. 4, 1977).
54. 602 F.2d at 1345.
55. *Id.*
56. *Id.*
57. *Id.*

2. Same or Similar Facts Test

The Government's second argument was that the facts in *Starker I* were sufficiently "separable" from those in *Starker II* to make collateral estoppel inapplicable. The court analyzed the similarity of the facts under the new test set down in *Montana v. United States*.[58] Under the *Montana* test, collateral estoppel is applicable even though some facts differ in the two cases. However, the facts that differ must not be "essential to the judgment" or "of controlling significance" to the first case.[59] It must be pointed out, however, that *Montana* was decided prior to *Starker II* and subsequent to *Starker I*. Prior to the *Montana* decision, a collateral estoppel issue was analyzed under the *Sunnen* "separable facts" test.[60] The "separable facts" test held that if the rele-

58. 440 U.S. 147 (1979). In *Montana*, a contractor brought suit against the State of Montana contending that the Montana gross receipts tax unconstitutionally discriminated against the United States and companies with which it dealt. This first suit was financed and controlled by the United States. After the State of Montana won the first case, the United States decided, as it did in *Starker I*, not to appeal. The Court found that the United States' control of the first action put it in the same position it would have occupied had it instituted both actions in its own name.

In the contracts at issue in the *Montana* case, the contractors promised the United States that they would not take advantage of credits offered by the state as part of its tax package. In the contracts at issue in the second case, the contractors could take the state credits. The United States argued that in the first action the state court assumed that the credits, available but for the voluntary contract provision, could have entirely offset the tax. Under the later contracts, however, even where the credits could have been taken, it turned out that a complete offset was impossible. Therefore, citing Commissioner v. Sunnen, 333 U.S. 591 (1948), the United States argued that its case should not have been dismissed. The United States Supreme Court rejected this argument and limited *Sunnen* to cases where there had been a significant "change in the legal climate." 440 U.S. at 158. The test set out in *Montana* is that collateral estoppel will be applicable even though some facts differ in the two cases at issue, if the differing facts are not "essential to the judgment," or "of controlling significance" in the first case. 440 U.S. at 158.

59. 440 U.S. at 159-60.

60. 333 U.S. 591 (1948). In *Sunnen*, an inventor licensed his invention and assigned the licensed contracts and royalties to his wife. The issue was whether the inventor was liable for taxes on the income paid to his wife by the licensee under the contract in the years 1937 to 1941. In a previous litigation, the Board of Tax Appeals (now the Tax Court) had held that for the years 1929 to 1931, the taxpayer was not liable for payments made to his wife under a set of licenses entered into in 1928. In the second case, both the 1928 contracts and other contracts were involved.

The Court held that collateral estoppel was inapplicable under the separable facts test:

> [I]f the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does not govern the legal issues which recur in the second case. Thus the second proceeding may involve

vant facts in two cases are separable, even though they are similar or identical, collateral estoppel does not govern the legal issues which recur in the second case. Thus, the second proceeding may involve an instrument or transaction identical with, but in a separable form from, the one dealt with in the first proceeding.[61] The *Montana* decision limited the "separable facts" test to cases in which there had been a significant change in the legal climate. The *Starker* court held that it should apply the law that existed at the time the case was presented to the court.[62] Thus, the *Montana* test was deemed the applicable standard.

In *Starker I*, the court focused on the Starkers' reciprocal, yet non-simultaneous, exchange with Crown. The opinion indicated that the court did not consider the time span between transfers of titles significant. Therefore, the *Starker* court held that "[u]nder a fair reading of *Starker I* the length of time lapse is inconsequential"[63] and thereby concluded that *Starker II* was not distinguishable on that ground. The *Starker* court also stated: "[M]any of the transfers are identical to those in *Starker I*."[64] Accordingly, the *Starker* court held that collateral estoppel was applicable under the *Montana* test, to the nine parcels where T.J. received actual title. The court's determination of the Timian, Bi-Mart and Booth properties, where collateral estoppel was held inapplicable, will be addressed later in this note.[65]

3. Party to the Prior Litigation

Even though T.J. was not a party to *Starker I*, he sought to use that victory "offensively" to prevent the Government from relitigating the simultaneous transfer issue. The court of appeals held that collateral estoppel was applicable, because the Government,

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> an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. . . . Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment.

333 U.S. at 601-02 (citations omitted).

61. *Id.* at 602.

62. *See* Cort v. Ash, 422 U.S. 66, 76-77 (1975) (the Court held that a court should apply the law as it exists at the time the case is before the court). *See also* United States v. Fresno Unified School Dist., 592 F.2d 1088, 1093 (9th Cir. 1979) (a court is to apply the law in effect at the time it renders its decision, unless doing so would result in manifest injustice or there is statutory direction of legislative history to the contrary (citing *Ash*, 422 U.S. at 76-77)).

63. 602 F.2d at 1348.

64. Starker v. United States, 432 F. Supp. at 867.

65. *See* notes 72-141 *infra*, and accompanying text.

which was a party to the prior case, had a full and fair opportunity to litigate the issue in *Starker I*. Because of the $31,342 refund at stake in *Starker I*, the Government had sufficient incentive to litigate. The court declined to speculate on T.J.'s motives for not joining in *Starker I*, finding that T.J. had not engaged in a "wait-and-see" gamble to elude the binding force of the *Starker I* judgment.[66]

C. Impact of the Court's Holding as to Collateral Estoppel

The court's holding, regarding the first nine parcels, clearly shows that the *Montana* test should be utilized when analyzing the facts of two cases to determine whether collateral estoppel applies. This is important in that *Montana* limits *Sunnen*'s "separable facts" test to a rather narrow factual situation.[67] Pursuant to the *Montana* test, courts now have broader discretion in determining when to apply collateral estoppel.[68] This is of great importance to the practitioner because it permits greater usage of collateral estoppel, both defensively and offensively. However, it should be pointed out that when proceeding with collateral estoppel offensively, the courts, in their broad discretion, will not permit collateral estoppel where a party could have easily joined in an earlier action, or where the application of offensive estoppel would be unfair to the defendant.[69]

A word of caution is due concerning the use of collateral estoppel pursuant to the *Starker* analysis. The court in *Starker* found that T.J. had not taken a "wait-and-see" approach in the hope the prior action (*Starker I*) would result in a favorable judgment.[70] This is important, because under the *Montana* test the burden on the proponent of collateral estoppel has been removed with re-

66. 602 F.2d at 1349-50. The court stated T.J. should be allowed to use collateral estoppel, although pursuant to Rule 20 of the Federal Rules of Civil Procedure he technically would have to be joined as a party to the first suit. "The father's suit differs from that of his son in so many respects, however, that there are numerous possible explanations why T.J. Starker—or for that matter, Bruce and Elizabeth Starker—might have wanted the lawsuits tried separately." *Id.* at 1349 (footnote omitted).

67. *See* note 58 *supra*, and accompanying text.

68. *See* Jackson v. Hayakawa, 605 F.2d 1121 (9th Cir. 1979). The court stated: "[C]ourts are no longer bound by rigid definitions of the parties or their privies for the purposes of applying collateral estoppel or res judicata." *Id.* at 1126 (citing Montana v. United States, 440 U.S. 147 (1979)).

69. *See, e.g.*, Parklane Hosiery Co. v. Shore, 439 U.S. 322, 330-31 (1979).

70. 602 F.2d at 1349.

spect to the separable facts test: however, courts will not tolerate a "wait-and-see" approach, in the application of collateral estoppel, where it is the intent of the litigant to elude the binding force of a prior judgment.[71]

At this juncture it is appropriate to examine the *Starker* court's section 1031 analysis of the three properties that the Government was not collaterally estopped from litigating. This examination will be preceded by a brief history of section 1031 and the progression of the permissible nonsimultaneous exchange.

IV. LIKE KIND EXCHANGES

A. *History*

1. The Concept of Like Kind Exchanges

The first statutory acknowledgment that certain gains on exchanges of property would not be recognized for tax purposes was in the Revenue Act of 1921, section 202(c).[72] That section provided that no gain or loss would be recognized from exchanges of property unless the replacement property had a readily realizable market value. However, more important was another provision in the section that provided nonrecognition treatment for the exchange of property held for investment or productive use in trade or business.[73] In 1928, some relatively minor revisions were made,[74] leaving the current section 1031(a) substantially equivalent to the 1928 version.

The purpose of section 1031 and its predecessors, is to defer recognition of transactions where the taxpayer may have realized a gain or loss, but that gain or loss was still in investment form and the taxpayer was substantially in the same economic position (in

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71. *Id.* at 1349-50.

72. The Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227 (current version at I.R.C. § 1031) states in part:

> (c) For purposes of this title, on an exchange of property, real, personal, or mixed, for any other such property, no gain or loss shall be recognized unless the property received in the exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized . . . when any such property held for investment, or for productive use in trade or business . . . is exchanged for property of like kind or use.

73. *Id.* The House Committee, commenting on the above 1921 statute, noted:

> The proposed bill . . . [provides] that on an exchange of property no gain or loss shall be recognized unless the property received in exchange has a definite and readily realizable market value; and specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received has a readily realizable market value.

Id.

74. *See* Revenue Act of 1928, ch. 852, § 112(b), 45 Stat. 816, (now I.R.C. § 1031).

the sense of liquidity) after the transaction as he was prior to it. This so-called "continuity of investment" rationale serves as the primary justification behind the section.[75]

The transaction involved in *Starker* is a variation of the so-called "three-corner" exchange. In such a transaction, the taxpayer desires to exchange, rather than to sell his property outright. However, the potential buyer of the taxpayer's property owns no property that the taxpayer wishes to receive in the exchange. Therefore, the buyer purchases other suitable property from a third party, and then exchanges it for the property held by the taxpayer.[76]

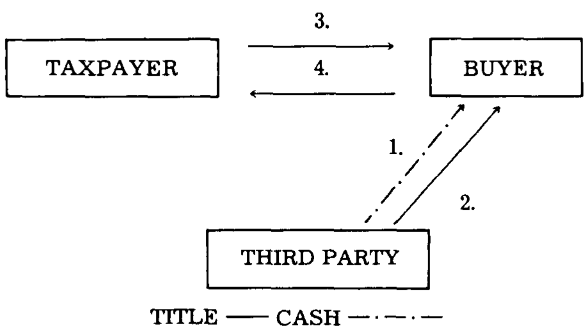
Several cases prior to *Starker* held the "three-corner" exchange to be an exchange eligible for nonrecognition treatment within

75. *See* H.R. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934). This report, cited in Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), recognized that the "continuity of investment" rationale was the main justification behind the section. Although the Eighth Circuit Court of Appeals, in Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), indicated later that the main justification for the statute was in alleviating the administrative problems which occurred with the valuation of gain or loss in like kind transactions.

> Subsections 112(b)(1) and 112(e) indicate the controlling policy and purpose of the section, that is, the non-recognition of gain or loss in transactions where neither is measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction.

192 F.2d at 159.

76. A three-corner exchange can be illustrated as follows:



(1) Buyer purchases suitable property to be exchanged with Taxpayer; often the property is designated by the Taxpayer; (2) Third Party transfers title to Buyer; (3 and 4) Taxpayer transfers title of his property to Buyer, and Buyer transfers exchange property to Taxpayer. Normally, before *Starker*, this was viewed as a simultaneous exchange of titles.

the meaning of section 1031.[77] In so holding, the courts permitted taxpayers great latitude in structuring transactions.[78] It is immaterial that an exchange is motivated by a wish to reduce or defer taxes.[79] The taxpayer may locate suitable property to be received in an exchange and may participate in the negotiations between the buyer and a third party for the acquisition of such property.[80] This is important because the Internal Revenue Service often argues that a taxpayer, who is active in the negotiations between the third party and the buyer for the exchange property, has constructively received payment from the buyer to purchase the property from the third party directly. This construction, if accepted, would be fatal to the taxpayer's attempt to have nonrecognition treatment of the transaction. However, under liberal construction by the courts, it appears that the *final result*, not the intermediate transactions and negotiations of a like kind exchange, is the determinative factor for which the transaction will qualify for nonrecognition under section 1031.[81]

2. Growth of the Permissible Nonsimultaneous Exchange

One of the first cases presenting the issue of simultaneous exchange was *Horne v. Commissioner*.[82] In *Horne*, the taxpayer

77. *See, e.g.*, Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963), *rev'd*, 38 T.C. 215 (1962). The party entered into escrow with no intention to sell for cash if it could be exchanged for other realty of like kind. The court held there was a valid § 1031 exchange and nonrecognition treatment. In W.D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948), there was an exchange with buyer purchasing real estate from a third party to exchange with the taxpayer. The court held there was a valid exchange and nonrecognition treatment was appropriate. In Coupe v. Commissioner, 52 T.C. 394 (1969), there was an exchange of farm and residence for property, cash and a note. The court held this a valid § 1031 exchange, and accordingly, there was nonrecognition treatment.

78. *See* note 77 *supra*, and accompanying text.

79. *See* Mercantile Trust Co. of Baltimore Trustees v. Commissioner, 32 B.T.A. 82 (1935). The court pointed out that the trustees could have sold the property or effected a tax-deferred exchange. The court also noted the fact that their motive for exchanging the property was to defer taxes. This however, did not invalidate an otherwise valid tax-deferred exchange. 32 B.T.A. at 87.

80. *See, e.g.*, Coastal Terminals, Inc. v. United States, 320 F.2d 333, 338 (4th Cir. 1963). Here, the taxpayer exchanged property with the oil company after negotiating with a third party to sell or exchange the property to the oil company. The court found a valid § 1031 exchange. In Alderson v. Commissioner, 317 F.2d 790, 793 (1963), the taxpayers entered into an agreement to sell a farm to the buyer, but the taxpayers intended to exchange property and to only take cash if an exchange could not be made. The exchange in fact took place after the taxpayer located a buyer. The buyer then purchased the property and exchanged it with the taxpayer for the exchange property. The court deemed it a valid § 1031 exchange. In Coupe v. Commissioner, 52 T.C. at 397-98, an agent of the taxpayer located an option for the purchase of a farm. This was purchased by the buyer and exchanged to taxpayer and was held a valid § 1031 exchange.

81. *See* note 80 *supra*.

82. 5 T.C. 250 (1945).

purchases a membership in the New York Coffee and Sugar Exchange, Inc. from one party. Nine days later the taxpayer sold a different membership in the same exchange to a different party. The taxpayer sought to claim a loss deduction on the sale of his membership certificate. The Commissioner contested the loss deduction, contending that the taxpayer qualified for tax-deferred exchange treatment. Although the sales took place nine days apart, the Tax Court held the transaction to constitute a tax-deferred exchange. Accordingly, because of the mandatory nature of section 1031, the taxpayer was precluded from deducting his loss.[83]

In 1962, the Tax Court applied section 1031 to another nonsimultaneous exchange, although without designating it as such. In *J.H. Baird Publishing Co. v. Commissioner*,[84] the taxpayer agreed to transfer his property in exchange for raw land, which was to be improved later according to the taxpayer's specifications. The taxpayer transferred his property on October 31, 1956, but retained use of the property rent-free for nine months, until the improvements on the exchange property were completed. When such improvements were completed, on July 19, 1957, the title to the exchange property was transferred to the taxpayer, and taxpayer relinquished the rent-free use of the property.

The Commissioner argued that the transaction did not qualify for tax-deferred exchange treatment, inasmuch as the taxpayer did not receive title to the exchange property until nine months after the transfer of title to the buyer. The Tax Court found for the taxpayer by concluding that there had been a simultaneous exchange on July 19, 1957. The court reasoned that on that date the taxpayer exchanged equitable title to its property for the legal title to the exchange property.[85] The court cited no authority for the contention that rent-free use of property is the equivalent to "equitable title." Therefore, the court effectively sanctioned a nonsimultaneous exchange to be treated as a simultaneous exchange, which granted the taxpayer the desired result: nonrecognition treatment.

83. *Id.* at 256. Section 1031(a) is not an elective provision. If the transaction qualifies under the section, the nonrecognition treatment is mandatory. Note the pertinent language of the provision: "No gain or loss *shall* be recognized . . . ." I.R.C. § 1031(a) (emphasis added).

84. 39 T.C. 608 (1962), *acq.*, 1963-2 C.B. 4.

85. 39 T.C. at 618.

Probably the most important case concerning nonsimultaneous exchanges, prior to the *Starker* decisions, was *Red Wing Carriers, Inc. v. Tomlinson*.[86] In *Red Wing*, the taxpayer attempted to structure a trade of old trucks for new trucks as a sale and purchase by delaying the time of each transaction. Under this setup, the taxpayer hoped to claim a depreciation deduction. However, the Commission contended that the transfers took place "[a]t or about the same time,"[87] and therefore, constituted a like kind exchange under section 1031. The court held that the exchange could not be transformed into a sale and purchase by an arbitrary separation of the time for the exchange of cash.[88] The court, thereby, approved nonrecognition treatment and denied the deduction.

In a more recent case, *Rutherford v. Commissioner*,[89] a taxpayer sought an investment tax credit and a depreciation deduction on the transfer of heifers, with an agreement to deliver to the exchange party certain offspring born to the heifers. The time span between the original transfer of the cattle and the transfer back of their offpring took as long as three years. Despite this substantial period of time, the Tax Court held that section 1031 applied, and therefore, barred the taxpayer's recognition of his loss and deduction.

The fact that the heifers, to be delivered by the taxpayer, were not in existence at the time of the transfer of the exchange property did not preclude the application of section 1031.[90]

These cases set the stage for *Starker*, where the taxpayer (T.J.) contended that the mere nonsimultaneity of transfer should not preclude a finding of a qualifying exchange under section 1031.

B. Court of Appeals' Analysis of the Section 1031 Issue

Three properties exchanged to T.J. did not come within the parameters of collateral estoppel. They include the Timian, Bi-Mart and Booth properties. Only the Booth property will be discussed herein.[91]

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86. 399 F.2d 652 (5th Cir. 1968).

87. *Id.* at 655.

88. *Id.* at 658.

89. 37 T.C.M. (CCH) 1851-77 (1978).

90. The court cited *Coastal Terminals, supra* note 78, and Biggs v. Commissioner, 69 T.C. 905, 916 (1978), for the proposition that a section 1031 exchange took place despite the lack of actual simultaneous transfers of title between the parties.

91. The court held that neither the Timian nor the Bi-Mart property qualified under section 1031 because titles to neither property were actually transferred to T.J. Starker. Rather, both were transferred directly to T.J.'s daughter Jean Roth. The court of appeals concluded that section 1031 required continuity of title and

1. Like Kind Determination of Booth Property

The most important aspect of *Starker* is the court of appeals' holding regarding the Booth property. The Booth property was commercial property, of which Crown purchased a third party's contract right to purchase. Crown then assigned this right to T.J. Starker. Title would not pass, pursuant to the agreement, until an existing life estate expired. In the meantime, the holders of the contract to purchase were entitled to possession of the property subject to certain restrictions. For instance, the purchasers were prohibited from removing improvements and were required to keep buildings and fences in good repair. The court also stated: "[A] substantial portion of the purchase price must be invested, with a fixed return to be paid to the purchaser of the life interest."[92] If any of these conditions were broken, the agreement provided that the seller could, at his election, rescind the contract.

The court held that despite these contingencies, T.J. received what was equivalent to a fee interest for purposes of section 1031. The court cited Treasury Regulation section 1.1031(a)-1(c),[93] under which a leasehold interest of thirty years or more is the equivalent of a fee interest for purposes of determining whether the properties exchanged are of like kind. The court stated that the interest received by T.J. was at least equivalent to the rights of a long-term lessee, plus an equitable fee subject to conditions precedent.[94] Thus, even though the Government argued that T.J. received personal property in the form of a contract right to purchase, the court held that for purposes of section 1031, the contract right to purchase was like kind property and hence, eligible for nonrecognition treatment.[95]

The second issue concerning the Booth property was whether simultaneous transfer was required for nonrecognition treatment

since T.J. never was actually vested in title to either the Bi-Mart or Timian properties, they would not qualify for nonrecognition treatment. 602 F.2d at 1350-51.

The Timian property was subsequently used by T.J. as his personal residence which would also disqualify it for nonrecognition treatment, since it was not held for "investment or business purpose." *Id. See* I.R.C. § 1031(a).

92. 602 F.2d at 1351.

93. Treas. Regs. § 1. 1031(a)-1(c)(a) provides that no gain or loss is recognized if "[a] taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved for unimproved real estate. . . ."

94. 602 F.2d at 1351.

95. *Id.* at 1352.

under section 1031. The facts indicated that T.J. did not receive the fee equivalent to the Booth property at the time he conveyed his property to Crown. The Government contended that under Treasury Regulation section 1.1002-(1)(b),[96] all exceptions to the general rule that gain and losses are recognized must be construed narrowly.[97] In other words, the exchange must satisfy the underlying purpose for which exchanges are allowed nonrecognition treatment.[98]

However, the court concluded that the underlying purpose of section 1031 was not altogether clear.[99] The main reason behind section 1031 appeared to be that Congress was sympathetic to taxpayers who exchanged their property and who did not have the necessary cash to pay a capital gains tax when the exchange

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96. Treas. Regs. § 1. 1002-(1)(b) provide in pertinent part:

> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or underlying assumptions and purposes of the exception. Non-recognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. . . .

97. 602 F.2d at 1352.

98. The court remarked:

> The legislative history reveals that the provision [section 1031] was designed to avoid the imposition of a tax on those who do not 'cash in' on their investments in trade or business property. Congress appeared to be concerned that the taxpayer would not have the cash to pay the tax on the capital gain. . . . [T]his does not explain the precise limits of section 1031, however; if those taxpayers sell their property for cash and reinvest that cash in like-kind property, they cannot enjoy the section's benefits, even if reinvestment takes place just a few days after the sale. . . .

Id.

See note 73 *supra*, and accompanying text. The court's remarks concerning the legislative purpose of section 1031 make an excellent point for an amendment to section 1031. That point concerns the inequity that occurs when a taxpayer sells his property held for business or investment purposes and reinvests thereafter in like kind property. Although, immediately subsequent to the sale of his property, the taxpayer may be in a sufficiently liquid state to pay the ensuing tax; after he repurchases business property, he is in substantially the same position as the exchange taxpayer in respect to liquidity. One suggestion is that section 1031 be amended to include a "rollover" provision. This is simply a deferral of tax realized on gain up to the amount reinvested, as long as the party reinvests within a statutory time limit, for instance, an eighteen-month period. *See, e.g.*, I.R.C. §§ 1033-34. Other commentators have expressed general approval of this position. *See* Comment, *Section 1031 Exchanges: Step Transaction Analysis and the Need for Legislative Amendment*, 24 U.C.L.A. L. REV. 351 (1976); West and Chodrow, *New Case Points Up Planning Techniques in Tax-Free Exchanges of Real Estate*, 20 J. TAX. 52 (1964); Kantor, *Section 1031 Exchange of Like Kind Property: A Court in Trouble*, 22 SW. L.J. 517 (1968).

99. *See* note 98 *supra*, and accompanying text.

caused gain recognition.[100] This "liquidity" rationale, the court observed, was limited due to the fact that if a taxpayer sold his business property, and reinvested the proceeds of that sale in a like kind property, he would still have to pay tax on the gain although he would be in the same position as the exchange taxpayer with respect to liquidity. The inequity of this result is unquestioned.

The court believed the drafters of section 1031 had also considered the difficulty of gain or loss valuation of exchanged property.[101] Under section 1031(d), the taxpayer is allowed to transfer the basis of the property he exchanges to the property he receives.[102] Actually this only defers the valuation problem as well as the tax, until the exchanged property is disposed of in a manner in which gain or loss is recognized. This valuation rationale is also limited, because where exchanges take place between properties not of like kind, there is an equally difficult valuation of gain or loss.[103] Therefore, it appears that the underlying purpose of section 1031 is to prevent the inequity of forcing the taxpayer to recognize a paper gain or loss,[104] along with the realization that although there may have been a gain or loss in one sense, there was in the popular and economic sense a mere

100. 602 F.2d at 1352.

101. *Id.*

102. I.R.C. § 1031(d). The statute provides in pertinent part:

> If property was acquired on an exchange described in this section . . . then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.

103. The court stated with regard to the valuation rationale:

> [S]o long as a single dollar in cash or other non-like-kind property ("boot") is received by the taxpayer along with like-kind property, valuation of both properties in the exchange becomes necessary. In that case, the taxpayer is liable for the gain realized, with the maximum liability being on the amount of cash or other "boot" received . . . . To compute the gain realized, one must place a value on the like-kind property received. Moreover, the nonrecognition provision applies only to like-kind exchanges, and not to other exchanges in which valuation is just as difficult. . . .

602 F.2d at 1352.

104. *See* Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959). The *Marsh* court held that the purpose of a simultaneous like kind exchange was to defer the recognition of gain or loss when property held for use in trade or business, or for investment, is exchanged solely for property of like kind so as to prevent the inequity of forcing the taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort.

change in the form of ownership.[105]

Another reason the court believed Treasury Regulations section 1.1002-1 would be inappropriate, if applied to section 1031 in this case, is the long line of precedent liberally construing the section.[106] The court cited *Biggs v. Commissioner*,[107] which held that a "four-corner"[108] exchange qualified for section 1031 nonrecognition treatment. In *Biggs*, the second party (buyer) did not want to take title to the property that the taxpayer (first party) ultimately desired. As a result, the taxpayer advanced money to a syndicate, which purchased the desired property from a fourth party and transferred it to the taxpayer.[109] The taxpayer then

105. *See* Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1943), *reh. denied*, 148 F.2d 208 (6th Cir. 1943).

106. *See, e.g.*, Biggs v. Commissioner, 69 T.C. 905, 913 (1978), where the court stated:

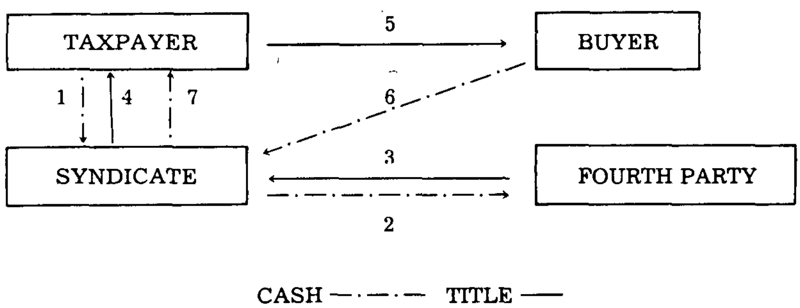
> In numerous cases, this type of transaction has been held to constitute an exchange within the meaning of section 1031. *E.g., Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963) *rev'g*, 38 T.C. 215 (1962) . . . . In so holding, the courts have permitted taxpayers great latitude in structuring transactions. Thus, it is immaterial that the exchange was motivated by a wish to reduce taxes. *Mercantile Trust Co. of Baltimore, et al., Trustees v. Commissioner*, [32 B.T.A. 87, 88 (1935)]. The taxpayer can locate suitable property to be received in exchange and can enter into negotiations for acquisition of such property. *Coast Terminals, Inc. v. United States*, 320 F.2d 333, 338 (4th Cir. 1963); *Alderson v. Commissioner*, 317 F.2d at 793; *Coupe v. Commissioner*, 52 T.C. at 397-98 (1969).

69 T.C. at 913 (citations omitted).

107. 69 T.C. 905 (1978).

108. *See* note 102 *supra*, and accompanying text.

109. In order to give the reader a better grasp of the "four-corner" exchange, as exemplified in *Biggs*, the following illustration is offered:



(1) Taxpayer transfers cash to purchase the exchange property to a Syndicate set up to complete the transaction; (2) Syndicate purchases exchange property from the Fourth Party; (3) Fourth Party transfers property to Syndicate; (4) Syndicate transfers exchange property to Taxpayer; (5) Taxpayer transfers his original property to Second Party; (6) Second party reimburses Syndicate amount paid for the exchange property; and (7) Syndicate reimburses Taxpayer amount put into Syndicate by Taxpayer. For a definition of terms used in this illustration, *see* note 2 *supra*, and accompanying text.

transferred his original property to a second party, and received back his cash advance to the syndicate, which ultimately came out of the pocket of the second party. The Tax Court found that the criteria for the application of section 1031, which included an exchange of property held for productive use in trade, business, or for investment for like kind property to be held for productive use in trade, business, or for investment, had been satisfied, since all the various transfers were part of an overall plan that exchanged like kind properties between the taxpayer and the second party. It should also be pointed out that since the third party (syndicate) realized no gain on the transaction, no tax was levied. But, in contrast, the fourth party, who sold his property to the syndicate, and ultimately exchanged to the taxpayer, did realize a gain on the sale of his property. Therefore, the fourth party was liable for tax on that gain.[110]

With the liberal construction given section 1031, the court analyzed two features of the Booth transaction most likely to trigger the recognition of gain. The first feature was the possibility of T.J. receiving cash in the transaction. As pointed out in the facts, one of the provisions of the exchange agreement between Crown and T.J. was that if suitable property could not be located to effectuate the exchange within five years, then the balance of the T.J. account on Crown's books would be paid in cash. The court relied upon *Alderson v. Commissioner*,[111] which held that the mere possibility of receiving cash would not disqualify an otherwise qualified exchange under section 1031, where, from the outset, the intent of the parties was to exchange like kind property and, in fact, the exchange had taken place.[112] This holding was in accord

110. *See* I.R.C. § 1001(c) (repealed by act of Oct. 4, 1976, Pub. L. No. 94-455, Title XIX, § 1901(b) 28(B)(i), 90 Stat. 1799) which provided: "Except as otherwise provided in this subtitle, on the sale or exchange of property, the entire amount of the gain or loss . . . [realized] shall be recognized."

111. 317 F.2d 790 (9th Cir. 1963). *See* note 77 *supra*, and accompanying text.

112. 317 F.2d at 793. In *Alderson*, the taxpayer signed an agreement to sell his property. However, it was the taxpayer's intent to exchange properties if suitable properties could be located. Escrow was entered to sell taxpayer's property for cash. However, before escrow was closed, suitable like kind property was located. The escrow was amended to provide that the buyer would acquire the described realty and exchange it for taxpayer's realty. The court held that the exchange qualified for section 1031 treatment. "[T]rue, the intermediate acts of the parties could have been closer to and have more precisely depicted the ultimate desired result, but what actually occurred . . . was an exchange of deeds between . . . [the parties] which [qualified as an exchange under section 1031]. . . ." *Id.*

with *Mercantile Trust Co. of Baltimore v. Commissioner*,[113] which allowed the taxpayer to receive nonrecognition treatment by virtue of its intention to exchange properties, rather than receive cash, if an exchange could be arranged to the satisfaction of the parties. Since T.J. never received any cash and because his intention was to exchange like kind properties and because like kind properties were exchanged, the court held *Alderson* was controlling.[114] Thus, section 1031 was applicable to the Booth property transaction.

However, the Government contended that the *Starker II* transaction was distinguishable from *Alderson*. The Government pointed out that in *Alderson*, although there had been a possibility of receiving cash at the time of the exchange agreement, there was no possibility of receiving cash at the time the taxpayer transferred his property pursuant to the argument.[115] However, the court did not find this distinction to be of importance.

2. Simultaneous Transfer

In the previously discussed *Red Wing*[116] case, the Government argued that the mutual transfer of trucks occurring "at or about" the same time was, in fact, an exchange under section 1031.[117] In *Red Wing*, a taxpayer attempted to deduct a loss on the deprecia-

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113. 32 B.T.A. 82 (1935). *See* note 76 *supra*, and accompanying text.

114. The intention of the parties is important in analyzing whether or not the transaction will qualify under section 1031. *See* Carlton v. United States, 255 F. Supp. 812 (S.D. Fla. 1966). *Carlton* involved a transaction whereby the taxpayers, who had given an option on their ranch property, negotiated to acquire other ranch property. They intended to make a tax-free exchange, in which the optionee contracted to buy other property and assigned the contract to the taxpayers at the time of sale of the taxpayer's ranch. The court held that this did not qualify as a tax-free exchange, since title never vested in the optionee. In discussing the import of the intent of the parties, the court also pointed out "intentions alone are not enough. It is what is done; not what might have been done that controls." *Id.* at 817 (citing Rogers v. Commissioner, 44 T.C. 126, 136 (1965)). However, the court in Coastal Terminals, Inc. v. United States, 207 F. Supp. 560, (E.D.S.C. 1962), *aff'd*, 320 F.2d 333 (4th Cir. 1962), held that a transaction by which property is exchanged solely for property of like kind cannot, for tax purposes, be separated into its component parts in order to accomplish the exchange. The *actual intention* of the parties and the accomplished transaction, rather than the separate intermediate steps, govern. *Id.* at 562. *Contra*, Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968).

However, the most important fact in determining whether the transaction will qualify for nonrecognition treatment is the substance of the transaction. *See* Red Wing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968). The *Red Wing* court stated that taxation is transactional, not cuneiform, and tax laws are not so supple that scraps of paper, regardless of their calligraphy, can transmit trade-ins into sales. *Id.* at 659.

115. 602 F.2d at 1354.

116. 399 F.2d 652 (5th Cir. 1968). *See* notes 80, 81 *supra*, and accompanying text.

117. 399 F.2d at 655.

tion of its old trucks exchanged for new trucks. The parent corporation transferred its old trucks to a subsidiary and purchased new trucks for cash from a dealer. The subsidiary sold the old trucks to the same dealer for cash. The court of appeals disallowed the loss deduction under section 1031. That court viewed the transaction as a whole, and despite the obvious lack of simultaneous transfers, held that the transaction qualified under section 1031.[118] The court also stated that "[t]he buying and selling [of the trucks] were synchronous parts meshed into the same transaction and not independent transactions."[119] This statement shows that the court was clearly more concerned about the substance of the transaction than the form of the transaction.[120]

In *Starker* the Government contended that *Red Wing* was distinguishable in that the Starker transfers were separated by a "substantial" period of time.[121] The court declined to make such a distinction, but offered no analysis to support the holding.[122]

It is important to note here that the Commissioner apparently tolerated the lack of simultaneous transfer in *Red Wing*, where it was to the Government's advantage to do so. In *Red Wing*, the taxpayer separated the disposal of the old trucks by a period of time so that section 1031 would not be applicable. By doing so, the taxpayer hoped to deduct the loss on the transaction.[123] By piercing the form of the *Red Wing* transaction, and thereby putting it within section 1031, the Commissioner saved the Government $66,630.33.[124]

However, as evident in *Starker*, the court is apparently not go-

118. *Id. See* note 87 *supra*, and accompanying text.

119. 399 F.2d at 656.

120. The fifth circuit in *Red Wing* also stated: "[T]he courts may open the shell and look inside to determine the substance of the transaction." 399 F.2d at 657. *See generally* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (the incidence of taxation depends upon the substance of the transaction); Helvering v. Lazarus, 308 U.S. 252, 255 (1939) (in the field of taxation, the courts are concerned with the realities and substance of the transaction); Gregory v. Helvering, 293 U.S. 465, 469 (1935) (the court will look through mere disguises and find the real character of a transaction). *See also* Coastal Terminals, Inc. v. United States, 207 F. Supp. 560, 562 (E.D.S.C. 1962), *aff'd*, 320 F.2d 333 (4th Cir. 1963), where this rule was applied in a section 1031 case.

121. 602 F.2d at 1355.

122. *Id.* In fact the court, in addressing the issue of the "substantial" period of time separating the transactions involved in *Starker*, declined to draw a line between the differing time periods. *Id.*

123. 399 F.2d at 654.

124. *Id.*

ing to allow the Internal Revenue Service to argue successfully in one instance, that there can be a valid section 1031 exchange despite the lack of simultaneous transfers of title, as in *Red Wing*, and in the next instance, argue that there cannot be a valid section 1031 exchange unless there are simultaneous transfers of title, as in *Starker*. In other words, the court is requiring the Internal Revenue Service to be consistent with respect to its treatment of nonsimultaneous exchanges by declining to make the distinction in *Starker* that the transactions were separated by a "substantial" period of time.

This holding clearly opens a new door concerning the applicability of section 1031, and perhaps more importantly, it offers a pragmatic approach in analyzing section 1031 exchanges. That approach is to consider the purposes of the statute and to analyze its application to the particular facts of the case under existing precedent.[125] Pursuant to this approach, the court found that the purpose of the statute was to defer the recognition of gain or loss in the transaction where the taxpayer did not "cash in" or "close out" his investment. The court stated:

> To impose a tax on the event of a deed transfer upon a signing of an exchange agreement could bring about the very result section 1031 was designed to prevent: '[T]he inequity . . . of forcing a taxpayer to recognize a paper gain which is still tied up in a continuing investment of the same sort.'[126]

This point is well taken by the court in that if T.J. was required to recognize the gain in his transaction with Crown, he would have to recognize a paper gain because he realized no cash in the transaction with Crown.

3. Chose in Action Argument

The Government next argued that the contract to purchase the Booth property was merely a chose in action[127] and precluded from nonrecognition treatment under section 1031.[128] The court agreed with the Government that the contract was a chose in action, but held that it qualified for nonrecognition treatment despite the statutory language of section 1031.[129] The court's rationale was that "title" to real property, like a contract right to purchase property, is nothing more than a "bundle of potential

125. 602 F.2d at 1355.

126. *Id.* (citing Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959)).

127. 602 F.2d at 1355-56.

128. I.R.C. § 1031(a) states in pertinent part: "no gain or loss shall be recognized if property [is] held for productive use in trade or business or for investment (not including stock in trade or . . . *choses in action* . . . .)" (emphasis added).

129. I.R.C. § 1031(a).

causes of action: for trespass, to quiet title, for interference with quiet enjoyment, and so on."[130] Since the bundle of rights associated with ownership is not precluded under section 1031, the court believed that the contractual rights to assume such ownership should not be precluded either. The court stated:

> Even if the contract right includes the possibility of the taxpayer receiving something other than ownership of like-kind property, we hold that it is still of like-kind with ownership for tax purposes when the taxpayer prefers property to cash before and throughout the executory period, and only like-kind property is ultimately received.[131]

This statement clearly shows that the court was more concerned with the realities of the transaction rather than mere speculation of what possibly could have transpired. T.J. did transfer his property to Crown and, in return, received title, or a contract right equivalent to title for section 1031 purposes. T.J. received no cash in the transaction and thus section 1031 was rightly and justly applied to his exchange with Crown. Under this rationale, the court held that the Booth property qualified for like kind treatment and nonrecognition of gain under section 1031.

The final issue the court addressed was the growth factor.[132] The Government argued and the court agreed that the growth factor incorporated into the exchange agreement was merely disguised interest and taxable as ordinary income.[133]

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130. 602 F.2d at 1355.

131. *Id.*

132. T.J. and Crown had a provision in their exchange agreement whereby a six percent growth factor would be credited to T.J.'s account annually, for the growth of the timber. The Government contended that the growth factor on the timber was merely disguised interest and therefore taxable as ordinary gain.

133. T.J. contended that the six percent growth provision merely compensated him for the timber growth on the property he transferred to Crown. The provision would do so, from the time of the transfer, until his credit balance was extinguished.

The court, while recognizing that T.J.'s argument was not without some biological merit, held that because T.J. bore no risk of loss after he conveyed title to Crown, the six percent growth factor was merely "compensation for the forbearance of money" and therefore, was disguised interest. The court stated: "Starker and Crown, as sophisticated managers of timberland, presumably knew about fire, blowdown, bugkill, government regulations, and other risks that ordinarily pass with title unless otherwise allocated in transactions spread over time." 602 F.2d at 1356 n.13. The court's holding is flexible in that it does not preclude a growth factor from being categorized as a capital asset. But, it does require the parties to document their intent, and for the growth factor to be treated as a capital asset and to, therefore, receive capital gain treatment, the documentation must show that the party claiming the capital gain also bore the risk of loss to that capital gain. *See* United States v. Midland-Ross Corp., 381 U.S. 54 (1965). "Earned original issue discount serves the same function as stated interest, concededly ordinary in-

C. Impact of Section 1031 Discussion

The issue remains open concerning what length of time would be tolerated between transfers of title in order to qualify as a simultaneous exchange under section 1031. The terms of T.J.'s contract allowed up to five years to make the exchange, although the actual period was only two years. Whether or not the period could have been five, ten, or fifteen years was left unanswered.[134] This question should be answered by Congress.[135]

Starker should have far-reaching effects on the real estate investment market. One of the major difficulties in effecting tax-deferred exchanges has been the complexity of arranging a simultaneous exchange of titles.[136] With this artificial time constraint (simultaneous exchange of titles) removed, taxpayers will be more able to market their properties with a greater possibility of finding suitable exchange property. This will increase the incentive for many investors to exchange property otherwise unmarketable because of the difficulty of arranging a suitable exchange or the unbearable tax burden if sold for cash. When the only alternative is a sale (without the benefits of deferring taxes), the delayed exchange adds flexibility where there once was none.

However, the practitioner should be aware that it is generally not advisable for a taxpayer to transfer his property to the buyer without some guarantees that the buyer will be able and willing to purchase and transfer the designated property to the taxpayer.[137] One method in which the taxpayer can protect himself is to take, as security, a deed of trust against the taxpayer's for-

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come and a net capital asset; it is simply the compensation for the forbearance of money." *Id.* at 57; Deputy v. duPont, 308 U.S. 488 (1939). In the business world, "interest on indebtedness" means compensation for the forbearance of money. *Id.* at 498.

134. In addressing the issue of what length of time between exchanges of title, a taxpayer would be allowed while still receiving tax-deferred treatment, the court stated:

> Some administrative difficulties may surface as a result [of our decision leaving the treatment of an alleged exchange open until the receipt of consideration by the taxpayer]. Our role, however, is not necessarily to facilitate administration. It is to devine [sic] the meaning of the statute in a manner as consistent as possible with the intent of Congress and the prior holdings of the courts. If our holding today adds a degree of uncertainty to this area, Congress can clarify its meaning.

602 F.2d at 1356.

135. *See* note 98 *supra*, and accompanying text.

136. *See* note 9 *supra*, and accompanying text.

137. It should be noted that T.J. put his faith in the solvency of Crown to make the necessary acquisitions over the five year period without the benefit of security. It must be pointed out that T.J. was undoubtedly aware of Crown's outstanding credit rating. Standard & Poor's rating service rated the Crown Zellerbach Corporation as A-, indicating an excellent credit rating. STANDARD & POOR'S CORP. STOCK REPORTS—NEW YORK STOCK EXCHANGE ¶ 692 (Oct. 1979).

mer property, or to take collateral security from the buyer. The security should not be taken to secure a promissory note given the taxpayer for the purchase price, but rather, to secure the obligation under the exchange agreement to purchase like kind property and to convey that property to the taxpayer. A provision liquidating the obligation to an amount equal to the agreed value of the taxpayer's property in the event of a default would also be required. This would protect the taxpayer by contractually binding the parties to an agreed amount of damages in case of a default. The main problem with this approach is that the buyer may be unwilling to cooperate in the exchange to this degree. From the taxpayer's point of view, the problem is that he is conveying his property and giving up possession, while receiving no down payment.

Many other arrangements are possible.[138] All agreements, however, must contain the following three essentials: first, the intent to make an exchange;[139] second, the avoidance by the transferor of the receipt of cash or even the right to receive or control cash;[140] and third, proper documentation.[141]

138. Another possibility is to deposit the funds, used to purchase the exchange property, into a bank account in which the exchange party and the taxpayer are joint signatories. This alternative assures the taxpayer that the funds will not be used improperly by the exchange party. However, the Internal Revenue Service may claim the taxpayer has "constructive receipt" of the funds and thus, deny the tax-free exchange. *See* Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

139. *See* note 114 *supra*, and accompanying text.

140. Of course the receipt of cash by the taxpayer would result in the recognition of ordinary gain. *See* note 6 *supra*, and accompanying text. The danger to the taxpayer, if he has the right to receive or control cash, is that the Internal Revenue Service may argue that the taxpayer constructively received the cash thus taking the transaction out of the parameters of section 1031. *See, e.g.*, Carlton v. United States, 385 F.2d 238 (5th Cir. 1967) (the IRS successfully argued that the taxpayer constructively received funds when the buyer deposited funds with taxpayer although taxpayer had the contractual right to require the buyer to purchase property to be exchanged); Rogers v. Commissioner, 44 T.C. 126 (1965), *aff'd*, 377 F.2d 534 (9th Cir. 1967); Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968).

A recent letter ruling by the Internal Revenue Service indicates that the use of depository funds paid in consideration for the taxpayer's property will be approved, at least as long as the parties are careful to keep the funds out of the taxpayer's control. IRS Rev. Rul. 7938087 (June 22, 1978). A note of caution should be interjected before advising a taxpayer-client to rely on this private letter ruling. The ruling was issued before the ninth circuit's decision in *Starker* and appears inconsistent with the Government's position in *Starker*. A ruling after the ninth circuit decision would more likely reflect a relaxation in the Government's position.

141. *See* note 144 *infra*, and accompanying text.

V. Conclusion

Starker is important in the area of collateral estoppel because it applies the new *Montana* test to determine the requisite degree of similarity between the facts of two cases to invoke collateral estoppel. In that test, as long as the facts that differ were not essential to the judgment nor of "controlling significance" in an earlier case, collateral estoppel would apply in the subsequent case.

A more important aspect of *Starker*, however, is its holding that there is no necessity of strict simultaneous transfer of title, both in time and substance, in order for section 1031 to apply. By also holding the contract to purchase as a "chose in action" which qualified under section 1031, the court opens many opportunities for exchanges of like kind property that would not have been possible before *Starker*.[142]

It must be remembered though, that pitfalls still abound in this area and careful planning is a necessity in order for the taxpayer to receive the desired results.[143] Careful documentation is critical because courts will often use this documentation to determine the intent and activities of the parties involved.[144] The taxpayer should not, under the exchange agreement, be able to call off the exchange and receive cash held in escrow as a protection against an insolvent buyer. If the taxpayer has this right from the outset, he may be viewed as having received funds instead of like kind property, and thereby, be taxed on his gain as if he had sold the property outright.

Although *Starker* creates many opportunities for investors and property owners, the approach to a *Starker* nonsimultaneous like kind exchange should be one of caution.

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142. This is because the court has equated a contract to purchase (a chose in action) with like kind property. Therefore properties previously not within the bounds of like kind property will be available for tax-free exchange treatment.

143. For example, if the taxpayer has the right to change the agreement from an exchange to a sale, and funds are held in an escrow account for the purchase of the exchange property, the Internal Revenue Service may contend there is a "constructive receipt" of that money by the taxpayer. Thus, the taxpayer would be required to pay a tax on any gain from that transaction. *See* note 138 *supra*.

144. *See, e.g.*, 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975) (the court used documentation to determine intent); Rogers v. Commissioner, 44 T.C. 126 (1965) (lack of documentation concerning intent and transaction was a factor in decisions against the taxpayer); J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), *acq.*, 1963-2 C.B. 4 (documentation used to show intent to exchange).